

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:NR:DAL:2OKL:TL-N-3902-00  
CGMcLoughlin

date: MAY 8 2001

to: Team 1636, Large and Mid-size Business Division,  
Retailers, Food and Pharmaceuticals  
Attn: John Clyburn

from: Associate Area Counsel (LMSB:DAL:2), Oklahoma City P.O.D. 2000-OKC

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subject: Request for Advisory Opinion

Taxpayer: [REDACTED]

Taxable year: [REDACTED]

EIN: [REDACTED]

This memorandum responds to your request for our views on whether a sufficient basis exists to reclassify as equity certain advances to the taxpayer. This memorandum should not be cited as precedent. As you are aware, a request for field service advice is currently pending with the National Office, Chief Counsel, concerning the application of collateral estoppel to the debt/equity issue. Due to the outstanding field service advice request, we express no views on the collateral estoppel issue at this time. The views expressed in this memorandum deal only with the merits of the basic debt/equity issue raised by [REDACTED] (" [REDACTED] ") advances to the taxpayer. For the reasons discussed below, we do not believe the government can sustain the debt/equity issue this cycle.

¶ This advisory is subject to the review procedures of CCDM (35)3(19)4(4). The CCDM procedures require us to transmit a copy of the memorandum to the National Office. The National Office has ten days from receipt of our memorandum to respond. The National Office may extend the review period if necessary. We will keep you informed of any delays.

DISCUSSION

[REDACTED]  
[REDACTED]. The prior cycle covered taxable years ending with or within [REDACTED] through [REDACTED]. In [REDACTED] (" [REDACTED] "), the Tax Court agreed with the

government's characterization of similar advances as equity. There, the Court applied the factors set forth in Estate of Nixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972) and classified the advances as equity. We have applied the same approach here. Unfortunately, the [REDACTED] facts differ significantly from the facts existing during the taxable years [REDACTED] through [REDACTED].

In [REDACTED] the Court used a substance over form approach when applying the Estate of Nixon factors. There, substantial objective evidence existed to show the substance of the related party transactions did not comport with its form. However, this type of strong objective evidence is lacking here. In looking at many of the factors in the current cycle, the parties appear to have acted in accordance with form of the transactions. The government simply has no objective evidence available to challenge those assertions. In other situations, the evidence is mixed with many of the factors being neutral. Given the lack of evidence to attack the transactions' form and the existence of mixed evidence on many of the Estate of Nixon factors, the government's case is simply not strong enough to pursue further. Below we have outlined the factual differences between [REDACTED] and the [REDACTED]

### Facts

#### a. Background

[REDACTED] ("[REDACTED]") was a wholly-owned subsidiary of a [REDACTED] public company, [REDACTED] ("[REDACTED]").<sup>1</sup> During the taxable years [REDACTED]-[REDACTED], [REDACTED] was a holding company and was the common parent for a consolidated return group which included [REDACTED] ("[REDACTED]") and [REDACTED] ("[REDACTED]"). Prior to [REDACTED], [REDACTED] also owned between [REDACTED]%-[REDACTED]% of the stock in a holding company, [REDACTED] ("[REDACTED]"). Prior to [REDACTED], [REDACTED] was the common parent for another consolidated return group which included [REDACTED] ("[REDACTED]"). On [REDACTED], [REDACTED] acquired sufficient [REDACTED] shares to terminate the [REDACTED] consolidated return group. Thereafter, [REDACTED] and its subsidiaries were members of the [REDACTED] consolidated return group. All of the corporations are accrual basis taxpayers.

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<sup>1</sup> [REDACTED] previously used [REDACTED] as its name.

The [REDACTED] entities conducted [REDACTED] in the United States during the taxable years [REDACTED]-[REDACTED]. All of these industries were in the process of consolidating in the United States at this time. [REDACTED] conducted similar [REDACTED]. The company desired to enter the larger and potentially more lucrative United States market. These expansion plans required a substantial amount of capital.

To facilitate the movement of capital into the United States, [REDACTED] established a wholly-owned [REDACTED] subsidiary, [REDACTED] (" [REDACTED] ").<sup>2</sup> [REDACTED] established a wholly-owned [REDACTED] corporation, [REDACTED] (" [REDACTED] "). When the U.S. operating companies required capital, [REDACTED] advanced funds to [REDACTED] as equity or as debt. [REDACTED] then advanced the funds to [REDACTED], in turn, transferred the funds to one of the U.S. operating companies.<sup>3</sup> [REDACTED] and the U.S. operating companies booked the advances as debt for financial and tax purposes.

The structure, on its face, had several potential tax benefits. The structure purported to permit [REDACTED] and the U.S. operating companies to deduct "interest" accrued on the advances. The "interest" accrued by [REDACTED] on the advances was not subject to U.S. income tax. Due to the [REDACTED] tax treaty in effect at that time, "payments" of "interest" on advances to [REDACTED] and the U.S. operating companies were not subject to withholding tax under I.R.C. § 1442. Finally, provisions of the [REDACTED] revenue laws provided that little, if any, of the "interest" would be subject to tax in [REDACTED].

After the taxable years [REDACTED]-[REDACTED], [REDACTED] advanced additional funds to [REDACTED] and the U.S. operating companies. As of [REDACTED], [REDACTED] had \$ [REDACTED] in outstanding advances to the U.S. operating companies. Between [REDACTED], and [REDACTED], the total outstanding advances from [REDACTED] to [REDACTED] and the U.S. operating companies ranged from \$ [REDACTED] to [REDACTED].

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<sup>2</sup> [REDACTED] transferred its ownership in [REDACTED] to [REDACTED] prior to the taxable years [REDACTED]-[REDACTED]. [REDACTED] was a wholly-owned subsidiary of [REDACTED] during the taxable years [REDACTED]-[REDACTED].

<sup>3</sup> After the taxable years [REDACTED]-[REDACTED], [REDACTED] began making similar advances to [REDACTED].

\$ [REDACTED]. The total outstanding advances from [REDACTED] included amounts advanced during the taxable years ended [REDACTED]-[REDACTED] and amounts advanced after those taxable years.

The favorable tax treaty between the [REDACTED] and the United States, which exempted the "interest payments" to [REDACTED] from the I.R.C. § 1442 withholding tax, was scheduled to expire at the end of [REDACTED]. Thus, on [REDACTED], [REDACTED] and the U.S. operating companies shifted all the [REDACTED] advances to [REDACTED]. [REDACTED] is an [REDACTED] corporation wholly owned by [REDACTED]. The [REDACTED]-U.S. tax treaty retained withholding tax exemptions similar to the old [REDACTED]-U.S. tax treaty.

The parties transferred the advance balances from [REDACTED] to [REDACTED] using daylight loans from [REDACTED] (" [REDACTED]"). [REDACTED] supplied daylight loans to [REDACTED], [REDACTED] and the U.S. operating companies.<sup>4</sup> [REDACTED] and each of the U.S. operating companies borrowed sufficient funds from [REDACTED] to "pay" the outstanding interest and principal on the [REDACTED] advances. The total amount outstanding from [REDACTED] to [REDACTED] and the U.S. operating companies on [REDACTED], was \$ [REDACTED]. [REDACTED] and the U.S. operating companies transferred the borrowed funds to [REDACTED]. [REDACTED] transferred the funds to [REDACTED].

[REDACTED] booked the funds received from [REDACTED] as follows:

Redemption of shares held by [REDACTED]	\$ [REDACTED]
Loan repayment from [REDACTED] to [REDACTED]	[REDACTED]
Cash distribution from [REDACTED]	[REDACTED]
<b>Total</b>	<b>\$ [REDACTED]</b>

[REDACTED] then transferred the funds to [REDACTED]. [REDACTED] booked the funds transferred to [REDACTED] as follows:

Capital injection to [REDACTED]	\$ [REDACTED]
Investment in [REDACTED]	[REDACTED]
<b>Total</b>	<b>\$ [REDACTED]</b>

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<sup>4</sup> [REDACTED] charged only \$ [REDACTED] for all the daylight loans.

████ used the funds to make \$████ in advances to █████ and the U.S. operating companies on █████. The █████ advances equaled the outstanding █████ advances █████ which were "paid off" on █████. The █████ advances were as follows:

████	\$ █████
████	████
████	████
████	████
Total	\$ █████

The government challenged the █████ and █████ consolidated groups' "interest" deductions on █████ advances covering the taxable years ending with or within █████-████. The government asserted alternatively that: (a) the advances represented equity versus debt; and (b) I.R.C. § 267(a)(3) precluded an immediate deduction for the accrued "interest". The taxpayers disputed these determinations in Tax Court.<sup>5</sup>

In █████, the Tax Court determined the advances from █████ constituted equity and not debt. In its opinion, the Court determined that an aggregate \$████ in advances from █████ to the U.S. operating companies represented equity. The following reflects the advances outstanding on █████:

(a) █████ - \$████; (b) █████ - \$████; and (c) █████ - \$████.<sup>6</sup>

Prior to entry of a decision reflecting the Court's opinion, the taxpayer sought to settle the case. The settlement discussions dealt not only with the advances made during █████-████. In addition, the taxpayer and the government discussed the "interest" deducted for the taxable years █████-████, and for the period from █████, through █████.<sup>7</sup> After considerable discussions, the parties

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<sup>5</sup> The government also challenged the interest deductions claimed in succeeding taxable years. The taxpayers also disputed these determinations in other Tax Court proceedings.

<sup>6</sup> Later, █████ sold █████ and assumed █████'s obligations to █████.

<sup>7</sup> At that time, the █████-████ "interest" deductions were also the subject of several pending Tax Court cases.



Date	Entity	Advance
████████	████████	\$ ██████████
████████	████████	\$ ██████████
████████	████████	\$ ██████████
████████	████████	\$ ██████████
████████	████████	\$ ██████████
Total		\$ ██████████

████████ and the U.S. operating companies used ██████% of the ██████ new advances for capital expenditures or acquisitions. The remaining ██████% of the ██████ new advances were used to repay third party bank debt. Most of the \$ ██████████ in advances ██████ transferred to ██████ on ██████████, had been used for capital expenditures or acquisitions. Therefore, the vast majority of ██████ advances were used to acquire capital goods or to acquire new business operations.

████████ was more careful in documenting the advances than ██████ had been. ██████ documented all the advances with loan agreements and promissory notes. The loan agreements generally required quarterly interest and principal payments. The loan agreements usually had a ██████ year term with the principal being amortized over a ██████ year period. At maturity the loan agreements required a balloon payment of the unamortized principal. The loan agreements had terms similar to other loans ██████ and the U.S. operating companies obtained from unrelated third party lenders. The interest rates charged by ██████ also tracked the rates available to ██████ and the U.S. operating companies from third party lenders.

There are other differences that exist between the facts of the current cycle and those present in ██████████. Here, there are no postponement agreements or subordination agreements subordinating ██████'s rights under the loan agreements to other creditors. ██████ also did not effectively subordinate its rights under the loan agreements by systematically delaying payment of interest or principal required by the agreements.

Unlike in ██████████, ██████ had no pattern here of extending the maturity date for its advances. Instead, ██████ paid the principal as it came due, including the balloon payments at maturity. Between ██████████ and ██████████, ██████ and the U.S. operating companies made more than \$ ██████████ in principal





covered less than \$ [REDACTED] each. In contrast, [REDACTED] had \$ [REDACTED] in advances outstanding during the current cycle. No unrelated lender provided a loan facility of comparable size.

[REDACTED] and the U.S. operating companies had much better cash flow profiles and more liquid assets during the [REDACTED]-[REDACTED] cycle than those existing in [REDACTED]. The [REDACTED] budgets projected cash flow from operations of \$ [REDACTED] for [REDACTED], \$ [REDACTED] for [REDACTED], and \$ [REDACTED] for [REDACTED]. After reducing these figures for routine sustenance and expansionary capital expenditures, the budgets reflected available cash of \$ [REDACTED] for [REDACTED], \$ [REDACTED] for [REDACTED], and \$ [REDACTED] for [REDACTED]. If the acquisition capital expenditures are taken into account, the budgeted cash flow was (\$ [REDACTED]) for [REDACTED], (\$ [REDACTED]) for [REDACTED], and \$ [REDACTED] for [REDACTED]. The latter figures assume the taxpayers would fund acquisitions entirely from current cash.

In addition to the cash flow from operations, [REDACTED] and the U.S. operating companies had considerably more liquid assets available in this cycle than in [REDACTED]. The liquid assets came from several sources including capital contributions and proceeds from the sale of assets. For instance, [REDACTED] received [REDACTED] shares of [REDACTED], a publicly traded company, as a capital contribution. The shares eventually sold for \$ [REDACTED] in [REDACTED]. The companies also had substantial liquid assets received from selling some of their [REDACTED] and [REDACTED] businesses during the current examination cycle. Those liquid assets included a convertible pay-in-kind debenture from [REDACTED] with a value of \$ [REDACTED] and [REDACTED] stock valued at \$ [REDACTED]. After the close of the current examination cycle, [REDACTED] used the [REDACTED] debenture and the [REDACTED] stock to repay approximately \$ [REDACTED] of the [REDACTED] advances.

The financial ratios for [REDACTED] and the U.S. operating companies are somewhat of a mixed bag during the [REDACTED]-[REDACTED] examination cycle. [REDACTED] had capital deficits during this examination, leaving it with infinite debt/equity ratios. Yet, [REDACTED]'s, as well as most of the U.S. operating companies' financial ratios improved over those seen in [REDACTED]. [REDACTED]'s debt/equity ratio was [REDACTED] in [REDACTED], but improved to [REDACTED] in [REDACTED], [REDACTED] in [REDACTED] and [REDACTED] in [REDACTED]. [REDACTED] had good debt/equity ratios of [REDACTED] in [REDACTED], [REDACTED] in [REDACTED] and [REDACTED] in [REDACTED]. Transit debt/equity ratio improved steadily from [REDACTED] in [REDACTED] to [REDACTED] in [REDACTED] and [REDACTED] in [REDACTED]. These ratios and particularly the improving trends differ significantly from [REDACTED].

### Analysis

In Estate of Mixon, 464 F.2d at 402, the Fifth Circuit listed thirteen factors used to determine if an advance constitutes true debt. The factors include: (1) the name given the certificate evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result of the advance; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement. Id. The various factors are not of equal significance, and no one factor is controlling. Tyler v. Tomlinson, 414 F.2d 844 (5th Cir. 1969). However, less weight is given to the factors involving the form of a transaction where related are involved. United States v. Texas Farm Bureau, 725 F.2d 307, 312 (5th Cir. 1984).

In the current cycle, unlike [REDACTED], the factors favoring characterization as debt predominate. Many of the taxpayer's superficial attempts to satisfy the Estate of Mixon factors in [REDACTED], such as circular principal and interest payments, do not exist here. In addition, the taxpayers in this cycle show a greater ability to shoulder the economic burden of treating the advances as debt. When the Estate of Mixon factors are considered in their entirety, the government would have a very difficult time recharacterizing the [REDACTED] advances as equity. We have analyzed each Estate of Mixon factor below.

1. Names Given to the Certificates Evidencing the Indebtedness

This factor focuses upon the terms of the instruments executed by the parties. The issuance of a note weighs toward true debt, Estate of Mixon, 464 F.2d at 403, but is not dispositive. Where written agreements or instruments fail to reflect terms and conditions consistent with commercial lending arrangements, the name given the "debt" instrument should be given little weight. Family Group, Inc. v. Commissioner, 59 T.C. 660, 670 (1973); Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712, 722 (5th Cir 1972). Here, as in [REDACTED], [REDACTED] and the taxpayers had promissory notes and loan agreements covering the advances. The notes and loan agreements characterized the

advances as loans. While this factor is given little weight in related-party transactions, the factor points toward treating the [REDACTED] advances as debt.

## 2. Presence or Absence of a Fixed Maturity Date

The presence of a fixed maturity date can indicate that an advance is debt. Estate of Nixon, 464 F.2d at 404-405. No fixed maturity date in notes or agreements favors a finding that advances are equity. Tyler, 414 F.2d at 847-848. But, the right to enforce a maturity date is meaningless if the parties do not expect the recipient to repay. Foresun v. Commissioner, 41 T.C. 706, 717 (1964). Postponing maturity dates for long periods of time suggests that the nominal lender does not intend to require repayment and suggests an advance is equity. Slappey Drive Indus. Park v. United States, 561 F.2d 572, 583 (5th Cir. 1977).

The [REDACTED] notes all had fixed maturity dates. Generally, the notes had a [REDACTED] year term with the principal being amortized over a [REDACTED] year period. Thus, the notes required a large principal payment at maturity. However, unlike [REDACTED], there is no consistent pattern of extending the notes' maturity dates. In fact, the taxpayers paid each advance which reached its [REDACTED] year maturity date. In some cases, the notes were paid prior to the stated maturity dates. This factor favors treating the advances as debt.

## 3. The Source of Payments

Another factor is the source of payments. Estate of Nixon, 464 F.2d at 402. An advance is more likely equity if the recipient does not have liquid assets or reasonably anticipated cash flow available to repay the advance. Id. at 405; Segel v. Commissioner, 89 T.C. 816, 830-831 (1987). In [REDACTED] the taxpayers had little or no liquid assets and had insufficient cash flow to repay the advances. Thus, the Court found this factor supported treating the advances as equity. The situation is quite different with the [REDACTED] advances.

In this cycle, [REDACTED] and the U.S. operating companies had substantially better cash flow than in [REDACTED]. The budgeted EBITDA for [REDACTED], [REDACTED], and [REDACTED] was \$ [REDACTED], \$ [REDACTED], and \$ [REDACTED]. Once sustenance and expansionary capital expenditures are taken into account the cash available for [REDACTED], [REDACTED], and [REDACTED] was \$ [REDACTED], \$ [REDACTED], and \$ [REDACTED]. These latter figures provide sufficient cash flow to cover most of the [REDACTED] principal and interest payments. [REDACTED] and the U.S. operating companies would only have trouble making the required interest and principal payments if capital expenditures for

acquisitions are considered. However, the taxpayers typically did not pay for acquisitions from current cash flow. Instead, they usually financed acquisitions and amortized the costs over a period of time. Thus, it is unrealistic to assume current free cash flow would be totally consumed by acquisitions and the taxpayers would have inadequate funds to repay the advances.

Furthermore, [REDACTED] and the U.S. operating companies had substantial liquid assets during the current cycle available to repay the advances. Those liquid assets included \$ [REDACTED] of [REDACTED] stock received as a capital contribution. The liquid assets also included a \$ [REDACTED] [REDACTED] debenture and \$ [REDACTED] in [REDACTED] stock received from the disposition of some hazardous waste operations. [REDACTED] and the U.S. operating companies actually used the latter two assets to repay a substantial portion of the [REDACTED] advances. In light of these substantial liquid assets and the considerable cash flow from operations during this cycle, this factor supports treating the [REDACTED] advances as debt.

#### 4. Right to Enforce Payment

A definite right to repay an advance suggests that an advance is a loan. Estate of Mixon, 464 F.2d at 403-404. Even where instruments give a "lender" enforceable rights, these will be disregarded if the "lender" does not enforce the provisions. Tyler, 414 F.2d at 849. In contrast to [REDACTED], there is no evidence that the taxpayers and [REDACTED] understood the repayment rights would never be enforced. Unlike [REDACTED], which never required repayment, [REDACTED] received the periodic payments of principal and interest in accordance with the loan agreements. At maturity, the taxpayers made the balloon payments of principal due under the loan agreements. Nor is there any documentation, such as [REDACTED] board minutes reflecting an intent to forego enforcement of the loan agreements. Consequently, the right to enforce repayment will be recognized here. This factor supports treating the advances as debt.

#### 5. Participation Increase in Management

Additional rights to participate in corporate management, which result from an advance, favors treating the advance as a capital contribution. Estate of Mixon, 464 F.2d at 406; American Offshore, Inc. v. Commissioner, 97 T.C. 579, 603 (1991). As in [REDACTED], the [REDACTED] loan agreements gave [REDACTED] no additional rights to participate in the management of [REDACTED] and the U.S. operating companies. However, [REDACTED] already controlled both [REDACTED] and the taxpayers. Thus, as in [REDACTED], this factor is neutral.

6. Status of the Contribution in Relation to Regular Corporate Creditors

Whether an advance is equal to or subordinate to the claims of other regular corporate creditors may reflect if an advance is debt or equity. Estate of Nixon, 464 F.2d at 406. An advance's subordination to the claims of other general creditors increases a lender's risk and supports a finding that the advance is a capital contribution. Tyler, 414 F.2d at 848-849. Also, failure to demand timely payment may, in effect, subordinate intercompany debt to the rights of other creditors who receive payment. American Offshore, 97 T.C. at 603. With respect to this factor, the [REDACTED] advances differ significantly from the [REDACTED] advances in [REDACTED].

In [REDACTED], formal postponement agreements clearly limited [REDACTED]'s rights. The postponement agreements were enforceable under [REDACTED] law and subordinated [REDACTED]'s repayment rights to those of other creditors. Secondly, by perpetually failing to enforce its repayment rights, [REDACTED] effectively subordinated its rights to those of other creditors. This did not happen with the [REDACTED] advances.

In contrast, no formal postponement agreements or other subordination agreements exists which limit [REDACTED]'s right to require repayment of the advances. Furthermore, as discussed above, [REDACTED] had no history of failing to enforce its repayment rights. Instead of continually extending the payment and maturity dates, as was done in [REDACTED], [REDACTED] received payments of principal and interest in accordance with the loan agreement terms. Thus, this factor supports treating the [REDACTED] advances as debt.

7. Intent of the Parties

In ascertaining the intent of the parties, courts look "not, to mere labels or to the self-serving declarations of the parties, but to the more reliable criteria of the circumstances surrounding the transaction." Tyler, 414 F.2d at 850. Generally, the parties' intent is revealed most clearly by their conduct. Motel Corp. v. Commissioner, 54 T.C. 1433, 1436 (1970).

In [REDACTED] the Court determined intent by looking at:  
(a) [REDACTED]'s advance of considerable funds despite worsening financial conditions; (b) [REDACTED]'s failure to obtain security for the advances in face of deteriorating financial performance; (c) repeated extensions of loan maturities; (d) circular interest "payments" and [REDACTED]'s pattern of advancing additional funds whenever interest was due; and (e) both internal corporate

documents and representations to foreign tax authorities which reflected [REDACTED] had no expectation of repayment. Based on these objective facts, the Court found the parties never intended the advances to be debt. We do not have this type of evidence in the current cycle.

The financial ratios and cash flow actually improved for LTI and the U.S. operating companies during the current examination cycle. The [REDACTED] loan agreements contained terms and rates consistent with those available from third party lenders. There was no pattern of extending the maturity dates for the advances, no circular interest "payments" and no pattern of advancing additional funds to pay interest or principal. Lastly, we found no internal or external statements reflecting an intent to treat the advances as part of the companies' permanent capital. Absent the damaging objective facts existing in [REDACTED], it would be difficult to show [REDACTED] intended to supply equity to [REDACTED] and the U.S. operating companies. This factor tends to support a finding of debt, or is, at best, neutral.

#### 8. "Thin" or Inadequate Capitalization

Thin capitalization suggests equity if: (a) the ratio is initially high; (b) the parties realized the ratios would go higher; and (c) the recipient of the funds used a substantial portion of the funds to buy capital assets and to meet initial operating expenses. Estate of Mixon, 464 F.2d at 408. In this regard the current cycle differs significantly from [REDACTED]. With the exception of [REDACTED], the taxpayers' debt/equity ratios were respectable and generally moving in a positive direction. [REDACTED]'s debt/equity ratio was [REDACTED] in [REDACTED], but improved to [REDACTED] in [REDACTED], [REDACTED] in [REDACTED] and [REDACTED] in [REDACTED]. [REDACTED] had good debt/equity ratios of [REDACTED] in [REDACTED], [REDACTED] in [REDACTED] and [REDACTED] in [REDACTED]. [REDACTED]'s debt/equity ratio improved steadily from [REDACTED] in [REDACTED] to [REDACTED] in [REDACTED] and [REDACTED] in [REDACTED]. These debt/equity ratios do not reflect the type of leverage which suggest an advance is equity. For that reason, the taxpayers' debt/equity ratios support treating the advances as debt.

#### 9. Identity of Interest Between Creditor and Stockholder

Where advances are in direct proportion to stock ownership, the advances are more likely to be equity. Estate of Mixon, 464 F.2d at 409. Identity of interest between a creditor and shareholder is also relevant where, as here, the lender is affiliated with, but owns no stock in, the borrower corporation.

That the same individuals or entities own and control all the corporations involved is significant. American Offshore, 97 T.C. at 605; Texas Farm Bureau, 725 F.2d at 313.

In this cycle, [REDACTED] is in the equivalent position as [REDACTED] in [REDACTED]. There, [REDACTED] and its management team controlled both the U.S. operating companies and [REDACTED]. Even though there was no direct ownership interest between the U.S. operating companies and [REDACTED], the Court determined a sufficient relationship existed to treat the factor as neutral. We have the same control situation in this cycle with [REDACTED] and [REDACTED] and the U.S. operating companies. [REDACTED], a subsidiary of [REDACTED], owns both [REDACTED] and [REDACTED]. The operations of [REDACTED] and all of the U.S. operating companies are controlled by [REDACTED] and its management team. Thus, this factor also should be treated as neutral here.

#### 10. Source and Frequency of Interest Payments

A failure to pay interest points strongly to equity, since a true lender expects to receive interest income. Regular payment of interest, in turn, indicates debt. Estate of Nixon, 464 F.2d at 409; Tyler, 414 F.2d at 849. In [REDACTED], the interest "payments" were merely part of a "carefully orchestrated circle" which did not alter [REDACTED]'s and the U.S. operating companies' economic status. [REDACTED] simply advanced additional funds to the U.S. operating companies whenever an interest "payment" was required. The interest payments made to [REDACTED] in the current cycle are quite different.

In the first place, no circular funds flow scheme existed during the current examination cycle. There are no instances where [REDACTED] advanced additional funds to [REDACTED] and the U.S. operating companies on or about the interest payment dates. Instead, [REDACTED] and U.S. operating companies typically obtained the funds needed to pay interest from unrelated third party lenders. By borrowing funds from third party lenders and paying the funds to [REDACTED], [REDACTED] and the U.S. operating companies did, in fact, change their economic status. Thereafter, [REDACTED] and the U.S. operating companies owed the borrowed sums to an independent party and not to an affiliate.

It is true that new [REDACTED] advances often were used to repay the third party loans. However, some period of time typically passed between the interest payment dates and the new [REDACTED] advances. The new advances typically covered more than simply the third party advances used to pay [REDACTED] interest. Consequently, it is difficult to trace an earlier third party loan used to pay [REDACTED] interest to a later [REDACTED] advance. The

government, thus, would have difficulty claiming [REDACTED] and the U.S. operating companies made no real interest payments with the third party loans proceeds. For those reasons, this factor probably supports characterizing the advances as debt, or, at best, is neutral.

11. Ability of the Corporation to Obtain Loans from Outside Lending Institutions

This factor examines the borrower company's ability to secure financing from outside lending institutions during the years in question. When a corporation can borrow money from outside sources when it receives an advance, it is more likely to be debt. Estate of Nixon, 464 F.2d at 410. The real question is whether an outside lender would have made the same loans on the same or similar terms. Segel, 89 T.C. at 832.

In the current cycle [REDACTED] and the U.S. operating companies had extensive lending relationships with third party lenders. The companies regularly used those credit facilities. The terms of the third party loan agreements were similar to the agreements with [REDACTED]. The rates charged by the third party lenders also mirrored the [REDACTED] rates. However, none of the third party lenders had commitments in the range of \$[REDACTED]-\$[REDACTED], the amount [REDACTED] and the U.S. operating companies had outstanding from [REDACTED]. The existence of numerous third party lending relationships somewhat supports the taxpayers' position. However, none of those commitments even approached the sums advanced by [REDACTED]. Therefore, no evidence exists to demonstrate third party lenders would have extended loans of equal size to [REDACTED] and the U.S. operating companies. Thus, this factor supports treating the advances as equity.

12. Extent to Which the Advance was Used to Acquire Capital Assets

A corporation's use of cash advances to acquire capital goods indicates the advance is equity. Estate of Nixon, 464 F.2d at 410. This is also true where an advance is used to expand an ongoing operation by acquiring an existing business. Plantation Patterns, 462 F.2d at 713-716, 722. In this situation, [REDACTED] and the U.S. operating companies used the vast majority of [REDACTED]'s advances on capital expenditures. Approximately [REDACTED]% of the new [REDACTED] advances and [REDACTED]% of the total [REDACTED] advances were used for capital expenditures. This factor supports treating the [REDACTED] advances as equity.



13. The Failure of the Borrower Corporation to Repay on the Due Date or to Seek a Postponement

A failure to repay the principal amounts when due supports a finding that the transactions did not create true debt. Estate of Nixon, 464 F.2d at 410-411. Slappey Drive, 561 F.2d at 582. In [REDACTED], the Court determined [REDACTED]'s continual extensions of principal maturity dates and renewals of advances suggested treating the advances as equity. Here again, the current examination cycle is quite different.

With respect to the advances outstanding in [REDACTED]-[REDACTED], [REDACTED] and the U.S. operating companies made timely principal payments. They made the required quarterly principal payments set forth in the loan agreements. In [REDACTED], [REDACTED], and [REDACTED], these principal payments represented \$ [REDACTED], \$ [REDACTED], and \$ [REDACTED], including substantial principal prepayments made in [REDACTED]. The taxpayers neither requested nor received maturity date extensions for the advances. These facts suggest treating the advances as debt.

Please contact Glenn McLoughlin at (405) 297-4803 if you have any questions. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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